Krishna Chandra College Department of Commerce

Sem-V, DSE-2, Unit – 3: Financial Institutions
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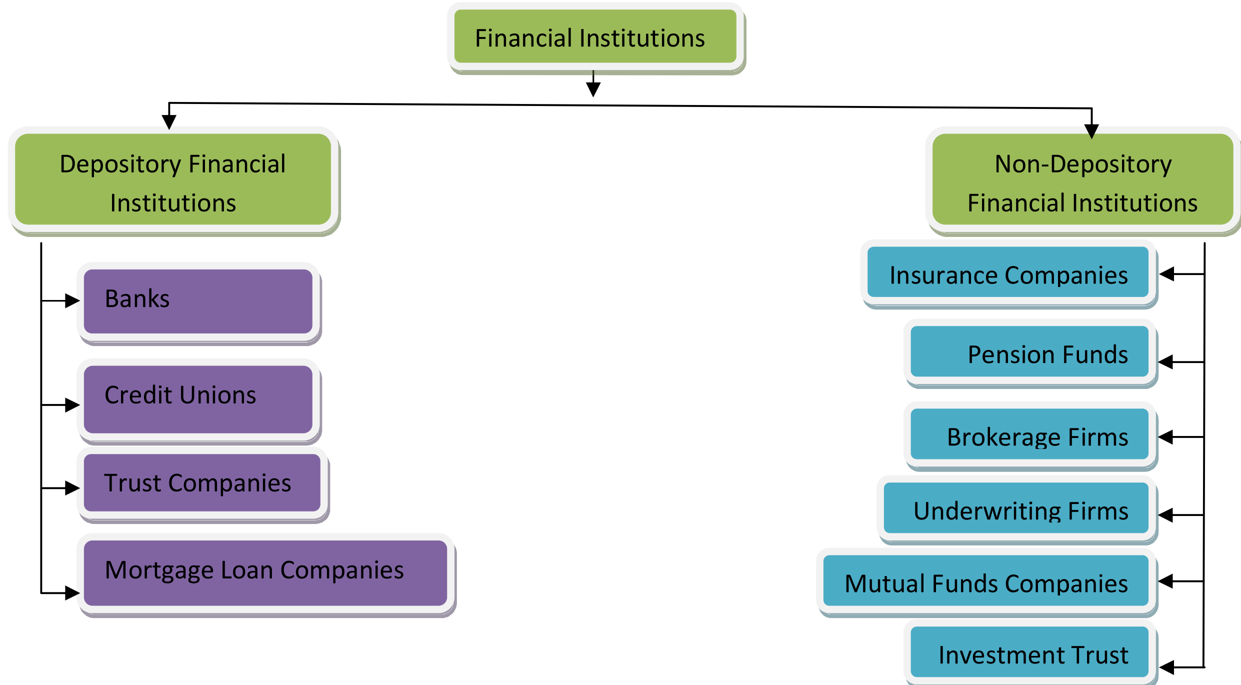
1. Financial Institutions

A financial Institution is an institution that provides financial services such as deposits, loans, investments, and currency exchange for its clients or members. FIs are also known as financial intermediaries because they collect the savings from the savers and pass on the same to desired channels.



2. Role of Financial Institution in the Financial System

- Financial institutions are financial intermediaries.
- They provide the means and mechanism of transferring the resources from those whose income is more than expenditure to those who need these resources for productive purposes.
- The savings of the savers will reach the borrowers through the financial intermediaries in the form of financial instruments such as shares, stocks, debentures, deposits, loans etc. Thus, they play the role of intermediate between the savings and investments.
- They provide safety, liquidity and ensure return for savings.
- Financial institutions develop the saving habit among the people.
- They mobilise huge amount of savings for the industrial development as a productive capital. The financial institutions supply capital to the small, medium and large scale industries in India in the form of capital, venture capital, and services to promote the industrial growth in India.
- These contribute for the growth and development of industries, agriculture etc.

3. Meaning of Commercial Banks

A commercial bank is a financial institution which performs the functions of accepting deposits from the general public and giving loans for investment with the aim of earning profit.

In fact, commercial banks, as their name suggests, axe profit-seeking institutions, i.e., they do banking business to earn profit.

4. Functions of Commercial Banks

(A) Primary Functions:

a) **It accepts deposits:**

A commercial bank accepts deposits in the form of current, savings and fixed deposits. It collects the surplus balances of the Individuals, firms and finances the temporary needs of commercial transactions. The first task is, therefore, the collection of the savings of the public. The bank does this by accepting deposits from its customers. Deposits are the lifeline of banks.

Deposits are of three types as under:

(i) Current account deposits:

Such deposits are payable on demand and are, therefore, called demand deposits. These can be withdrawn by the depositors any number of times depending upon the balance in the account. The bank does not pay any Interest on these deposits but provides cheque facilities. These accounts are generally maintained by businessmen and Industrialists who receive and make business payments of large amounts through cheques.

(ii) Fixed deposits (Time deposits):

Fixed deposits have a fixed period of maturity and are referred to as time deposits. These are deposits for a fixed term, i.e., period of time ranging from a few days to a few years. These are neither payable on demand nor they enjoy cheque facilities.

They can be withdrawn only after the maturity of the specified fixed period. They carry higher rate of interest. They are not treated as a part of money supply Recurring deposit in which a regular deposit of an agreed sum is made is also a variant of fixed deposits.

(iii) Savings account deposits:

These are deposits whose main objective is to save. Savings account is most suitable for individual households. They combine the features of both current account and fixed deposits.

They are payable on demand and also withdraw able by cheque. But bank gives this facility with some restrictions, e.g., a bank may allow four or five cheques in a month. Interest paid on savings account deposits in lesser than that of fixed deposit.

b) It gives loans and advances:

(i) Cash Credit:

An eligible borrower is first sanctioned a credit limit and within that limit he is allowed to withdraw a certain amount on a given security. The withdrawing power depends upon the borrower's current assets, the stock statement of which is submitted by him to the bank as the basis of security. Interest is charged by the bank on the drawn or utilised portion of credit (loan).

(ii) Demand Loans:

A loan which can be recalled on demand is called demand loan. There is no stated maturity. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. Those like security brokers whose credit needs fluctuate generally, take such loans on personal security and financial assets.

(iii) Short-term Loans:

Short-term loans are given against some security as personal loans to finance working capital or as priority sector advances. The entire amount is repaid either in one instalment or in a number of instalments over the period of loan.

c) **Investment:**

Commercial banks invest their surplus fund in 3 types of securities:

(i) Government securities, (ii) Other approved securities and (iii) Other securities. Banks earn interest on these securities.

(B) Secondary Functions:

Apart from the above-mentioned two primary (major) functions, commercial banks perform the following secondary functions also.

a) Discounting bills of exchange or bundles:

A bill of exchange represents a promise to pay a fixed amount of money at a specific point of time in future. It can also be encashed earlier through discounting process of a commercial bank. Alternatively, a bill of exchange is a document acknowledging an amount of money owed in consideration of goods received. It is a paper asset signed by the debtor and the creditor for a fixed amount payable on a fixed date. It works like this.

Suppose, A buys goods from B, he may not pay B immediately but instead give B a bill of exchange stating the amount of money owed and the time when A will settle the debt. Suppose, B wants the money immediately, he will present the bill of exchange (Hundi) to the bank for discounting. The bank will deduct the commission and pay to B the present value of the bill. When the bill matures after specified period, the bank will get payment from A.

b) Overdraft facility:

An overdraft is an advance given by allowing a customer keeping current account to overdraw his current account up to an agreed limit. It is a facility to a depositor for overdrawing the amount than the balance amount in his account.

In other words, depositors of current account make arrangement with the banks that in case a cheque has been drawn by them which are not covered by the deposit, then the bank should grant overdraft and honour the cheque. The security for overdraft is generally financial assets like shares, debentures, life insurance policies of the account holder, etc.

c) Agency functions of the bank:

The bank acts as an agent of its customers and gets commission for performing agency functions as under:

(i) Transfer of funds: It provides facility for cheap and easy remittance of funds from place-to-place through demand drafts, mail transfers, telegraphic transfers, etc.

(ii) Collection of funds: It collects funds through cheques, bills, bundles and demand drafts on behalf of its customers.

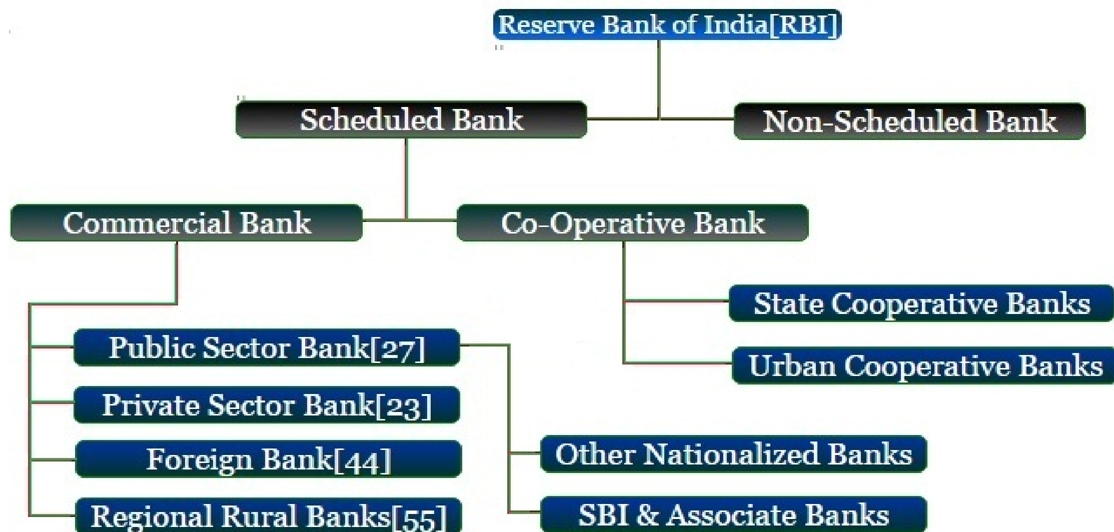
(iii) Payments of various items: It makes payment of taxes. Insurance premium, bills, etc. as per the directions of its customers.

(iv) Purchase and sale of shares and securities: It buys sells and keeps in safe custody securities and shares on behalf of its customers.

(v) Collection of dividends, interest on shares and debentures is made on behalf of its customers.

5. **Types of Banks: in India**

The following chart depicts main types of banks in India.



6. **Definition of Scheduled Banks:**

"Banks which have been included in the **second scheduled of the RBI Act, 1934"**. The banks included in this category should fulfil two conditions;
i. The paid up capital and **collected fund of the bank should not be less than Rs. 5 lac.**
ii. Any activity of the bank will not adversely affect the interests of the depositors.

7. **Definition of Non- Scheduled Banks:**

The banks which are **not included in the list of the scheduled banks** are called the Non-Scheduled Banks. Non- Scheduled Banks are also not eligible for having loans from the **RBI** for day to day activities but under the emergency conditions RBI can grant loan to them. Examples of this type of banks are:

a) Akhand Anand Co-Operative Bank Ltd
b) Alavi Co-Op Bank Ltd
c) Amarnath Co-operative Bank Ltd
d) Amod Nagrik Sahakari Bank Ltd
e) Amreli Nagrik Sahakari Bank Ltd

8. **Key differences between the Scheduled Banks and Non- Scheduled Banks are;**
   a) Scheduled banks follow the rules made by the RBI while Non-scheduled banks do not follow the rules made by the RBI.
   b) Scheduled banks are eligible for **inclusion in the second schedule to the Reserve Bank of India Act, 1934** while Non-scheduled banks are not included in the second schedule.
   c) **Scheduled banks are allowed to borrow money from RBI** for regular banking purposes while Non-scheduled banks are not allowed.
   d) Scheduled banks can become a member of clearing house while Non-scheduled banks can't.

e) Scheduled banks and Non-scheduled banks both need to maintain the Cash Reserve Ratio but Scheduled banks have to deposit this amount in the RBI while **Non-scheduled banks can deposit this amount with themselves.**

9. Merchant Bank

The term merchant bank refers to a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high-net-worth individuals (HWNIs). Merchant banks are experts in international trade, which makes them specialists in dealing with multinational corporations. Unlike retail or commercial banks, merchant banks do not provide financial services to the general public. Some of the largest merchant banks in the world include J.P. Morgan Chase, Goldman Sachs, and Citigroup.

10. Functions of Merchant banks

Merchant Banks in India and around the world perform the following functions as part of their standard operations –

- **Issue management**: Merchant Bankers advice their clients on the issuing of different types of shares such as equity shares, preference shares, and debentures, which are a type of debt instrument.
- **Credit Syndication**: The Merchant Banks provide loans to a specific set of clients for setting up or executing various projects.
- **Portfolio Counselling**: Merchant Banks also help their clients in investing and managing *Portfolios*, which are large investments consisting of a number of various financial instruments and investments.
- **Project Counselling**: Clients are advised on various procedural and financial aspects of their short or long-term projects.
- **Brokering in Stock Exchange**: Many Merchant Banks act as brokers of stock exchanges. They buy and sell shares of different types on behalf of their clients.
- **Advice on Expansion and Management**: Some Merchant Banks also provide advice to their customers on the expansion and modernization of their businesses. They advise on mergers, acquisitions and takeovers too.
- **Services to Private & Public Sector Units**: Merchant Bankers also offer many services to public & private sector units like helping in raising funds, marketing of securities, foreign collaborations and managing long-term finances.
- **Management of Interests and Dividends**: Merchant Banks also help their clients in the management of interest on and dividends on their invested shares, and regarding the rate of dividend as well as their timing.
- **Leasing Services**: Some Merchant Banks also help in leasing services where the lessor allows the use of specific assets to the lessee for a certain period on behalf of rentals or fees.

11. Difference between commercial bank and merchant bank

Basis for Comparison	Commercial Bank	Merchant Bank
Meaning	Commercial bank is a banking company established by a number of people for providing the basic banking functions i.e. accepting deposits and lending money to general public.	Merchant bank refers to the financial institution, that specializes in international trade and provide and array of services to its clients.
Governing Act/body	Regulated by Banking Regulation Act, 1949.	Rules and regulations designed by SEBI.
Engaged in	General banking business	Consultancy type business
Nature of loan extended	Debt-related	Equity-related
Exposure to risk	Less	Comparatively more
Role	Financier	Financial Advisor
Caters	Needs of general public.	Needs of corporate firms.

12. Commercial Bank Role in Project Finance and working Capital Finance

- Project Financing by Commercial Banks

Project finance is the long-term financing of infrastructure and industrial projects based upon non-recourse or limited alternative of financial structure where project debt and equity used to finance the project are paid back from the cash flow engendered by the project. Project finance is especially attractive to the private sector because companies can fund major projects off-balance-sheet.

Project Finance is one of the key focus areas in today's world because of continuous growth and expansion of the industries at a rapid rate. Project finance is a centuries-old form of financing high-risk, development-oriented projects. Project financing has been an integral part of financing options for infrastructure projects globally, both in developed and emerging markets.

They are most ordinarily non-recourse loans, which are fortified by the project assets and paid entirely from project cash flow, rather than from the general assets or creditworthiness of the project sponsors, a decision in part braced by financial modelling.

In India, local banks, both public sector and private sector, have been the only players in infra project financing (PF), with very little participation from international financial institutions (IFIs). This situation is not sustainable - with increasing demand for funds, and Indian banks reaching their prudential exposure limits, there is an urgent need for new instruments and new players in the financing market.

Commercial banks have always had an active role in project finance transactions. In fact, project finance is generally thought to have begun in the 1930s when a Dallas bank made a non-recourse loan to develop an oil and gas property. Project finance has been employed in almost all capital-intensive industries, particularly in transportation (aircraft, rail, and shipping), in mineral and other natural resource exploration and development (including oil and gas), and, most recently, in independent power projects.

Commercial banks can provide project financing because they are able to evaluate complex project financing transactions and to assess and assume the construction and performance risks usually involved in such financings. However, largely because of the short-term nature of a commercial bank's liabilities (its deposits), commercial bank participation is usually limited in amount, although banks closely monitor and control their project finance assets much as they do their other long-term assets. Project sponsors frequently seek financing through a "request for proposal" or "RFP" process, and several commercial banks are likely to form separate syndicates or "clubs" to respond to an RFP. The division of work within a syndicate is often functional, and has become quite efficient, with individual banks designated as technical agent, documentation agent, syndication agent, and variations thereof [1]. Several commercial banks or their affiliates have also provided development or mezzanine financing for projects. Some have even made equity investments in projects. Others have made equity commitments to, or equity investments in, pooled investment vehicles specifically targeted for project and other infrastructure investments.

- **Working Capital Financing by Commercial Banks**

The **working capital financing by commercial banks** is an important part of corporate finance. The small and medium scale businesses often face the requirements of credit for their business operations. The commercial banks offer special working capital financing services for the businesses.
Many a times the small and medium scale businesses fail to get the traditional loan from the banks. The businesses then need to go for the working capital financing from the banks. There are various forms of financing available for the working capital financing loans. The major categories of working capital financing by commercial banks are short-term loans, short-term credits, treasury lines and overdrafts.

The short term working capital financing are generally provided by the commercial banks over a short period of 3, 6, 9 or 12 months. The short term financing is addressed to deal with special purposes such as financing investments or financing the receivables. The commercial banks also offer short-term credit facilities that are generally used by the business on rotational basis in order to meet the general working capital financing requirement on a continuous basis. In case of the short-term credit facilities, the loans are generally offered for the term periods of 1 or 3 months. On the other hand, treasury lines are offered for non-standard tenors.

The commercial banks offer working capital financing services that are designed to suit the specific requirements of the businesses. The banks are backed with employees having sound knowledge in finance who are experienced to understand the needs of the business. These professionals also determine the criterion of the businesses and decide on the working capital cycle for the business. Generally, the working capital limits are valid for a specific time period and the loan is repayable on the demand.

With the working capital financing, the businesses can have loan against their income stream. This is considered to be the main facility of the working capital financing. The commercial banks can purchase the accounts receivables of the businesses and lend the credit on account of that. The commercial banks also offer working capital loans by acting as a lessee and holding the lease of business equipments.

13. Development finance Institutions

Development Financial Institutions are specialized institutions set up primarily to provide funds for low-capital projects or where their borrowers are unable to get it from commercial lenders, especially in developing countries. These development banks are usually majority-owned by national governments. The source of capital of these banks is national or international development funds. This ensures their creditworthiness and their ability to provide project finance in a very competitive rate.

14. Features of Development Banks

Following are the main characteristics or features of development banks:

- It is a specialized financial institution, provides medium and long-term finance to business units.
- Unlike commercial banks, it does not accept deposits from the public, It is not just a term-lending institution. It’s a multi-purpose financial institution.
- It is essentially a development-oriented bank. Its primary objective is to promote economic development by promoting investment and entrepreneurial activity in a developing economy. It encourages new and small entrepreneurs and seeks balanced regional growth.
- They provide financial assistance not only to the private sector but also to the public sector undertakings, It aims at promoting the saving and investment habit in the community.
- It does not compete with the normal channels of finance, i.e., finance already made available by the banks and other conventional financial institutions. Its major role is of a gap-filler, i. e., to fill up the deficiencies of the existing financial facilities.
- Its motive is to serve the public interest rather than to make profits. It works in the general interest of the nation.

15. Objectives of Development Finance Institutions

- They promote industrial growth.
- To develop backward areas.
- To create more employment opportunities.
- To generate more exports and encourage import substitution.
- To encourage modernization and improvement in technology.
- To promote more self-employment projects.
- To revive sick units.
- To improve the management of large industries by providing training.
- To remove regional disparities or regional imbalance.
- They promote science and technology in new areas by providing risk capital, and.
- To improve the capital market in the country.

16. Important functions of development banks

Or

Role of development banks in the Indian economy

In India, the role of DFIs is to support long term infrastructures of industry and agriculture. The DFIs were set up under the full control of both Central and State Governments. These institutions were used by the government for spurring economic growth and aid social development. The DFIs provide finance to all those entities which are not adequately served by the banks and capital markets like households, SMEs, and private corporations.

- **Promote and develop small-scale industries (SSI):** Development banks play an important role in the promotion and development of the small-scale sector. The government of India (GOI) started the Small Industries Development Bank of India (SIDBI) to provide medium and long-term loans to Small Scale Industries (SSI) units. SIDBI provides direct project finance and equipment finance to SSI units. It also refinances banks and financial institutions that provide seed capital, equipment finance, etc., to SSI units.

- **Finance the development of the housing sector:** Development banks provide finance for the development of the housing sector. GOI started the National Housing Bank (NHB) in 1988.

  NHB promotes the housing sector in the following ways:

  - It promotes and develops housing and financial institutions.
  - It refinances banks and financial institutions that provide credit to the housing sector.

- **Facilitate the development of large-scale industries (LSI)** : The development bank promotes and develops large-scale industries (LSI). Development financial institutions like IDBI, IFCI, etc., provide medium and long-term finance to the corporate sector. They provide merchant banking services, such as preparing project reports, doing feasibility studies, advising on the location of a project, and so on.

- **Help in the development of the agricultural sector and rural India:** Development banks like the National Bank for Agriculture & Rural Development (NABARD) helps in the development of agriculture. NABARD started in 1982 to provide refinance to banks, which provide credit to the agriculture sector and also for rural development activities. It coordinates the working of all financial institutions that provide credit to agriculture and rural development. It also provides training to agricultural banks and helps to conduct agricultural research.

- **Enhance the foreign trade: Development banks help to promote foreign trade**. The government of India started the Export-Import Bank of India (EXIM Bank) in 1982 to provide medium and long-term loans to exporters and importers from India. It provides Overseas Buyers Credit to buy Indian capital goods. Also, encourages abroad banks to provide finance to the buyers in their country to buy capital goods

from India.

- **Help to review (cure) sick industrial units:** Development banks help to revive (cure) sick-units. The government of India (GOI) started the Industrial Investment Bank of India (IIBI) to help sick units. IIBI is the main credit and reconstruction institution for a revival of sick units. It facilitates modernization, restructuring, and diversification of sick-units by providing credit and other services.

- **Encourage the development of Indian entrepreneurs:** Many development banks facilitate entrepreneurship development. NABARD, State Industrial Development Banks, and State Finance Corporations provide training to entrepreneurs in developing leadership and business management skills. They conduct seminars and workshops for the benefit of entrepreneurs.

- **Promote economic activities in backward regions:** The development bank facilitates rural and regional development. They provide finance for starting companies in backward areas. Also, they help companies in project management in such less-developed areas.

- **Contribute to the growth of capital markets:** The development bank contributes to the growth of capital markets. They invest in equity shares and debentures of various companies listed in India. Also, invest in mutual funds and facilitate the growth of capital markets in India.

17. Forms and Types of DFIs in India

Functionally, all-India institutions can be classified as:

(i) Term-lending institutions (IFCI Ltd., IDBI, IDFC Ltd., IIBI Ltd.) extending long- term finance to different industrial sectors,

(ii) Refinancing institutions (NABARD, SIDBI, NHB) extending refinance to banking as well as non-banking intermediaries for finance to agriculture, SSIs and housing sectors,

(iii) Sector-specific/specialised institutions (EXIM Bank, TFCI Ltd., REC Ltd., HUDCO Ltd., IREDA Ltd., PFC Ltd., IRFC Ltd.), and

(iv) Investment institutions (LIC, UTI, GIC, IFCI Venture Capital Funds Ltd., ICICI Venture Funds Management Co. Ltd.). State/regional level institutions are a distinct group and comprise various SFCs, SIDCs and NEDFi Ltd.

18. Major DFIs in India

- **Industrial Finance Corporation of India (IFCI Ltd.):**

It is India's first development finance institution, was set up in 1948 on July 1 under the Industrial Finance Corporation Act, 1948 as a statutory corporation to pioneer industrial credit to medium and large scale industries. The constitution of IFCI was changed in May 1993 from a statutory corporation to a company under the Companies Act, 1956 providing

the institutions with greater flexibility to respond to the needs of the rapidly changing financial system as also greater access to the capital markets.

The operations of IFCI's comprise project finance, financial services and corporate advisory services. It is providing long-term financial support to all the segments of the Indian industry, export promotion, import substitution, entrepreneurship development, pollution control, energy conservation and generation of both direct and indirect employment. It provides custodial and investor services, rating and venture capital services through its subsidiaries/ associate companies.

- **Industrial Credit and Investment Corporation (ICICI):**

It was established in 1955. It facilitated industrial development in line with economic objectives of the time. It evolved several new products to meet the changing needs of the corporate sector. It provided a range of wholesale banking products and services, including project finance, corporate finance, hybrid financial structures, syndication services, treasury-based financial solutions, cash flow based financial products, lease financing, equity financing, risk management tools as well as advisory services.

It also played a facilitating role in consolidation in various sectors of the Indian industry by funding mergers and acquisitions. In the context of the emerging competitive scenario in the financial sector ICICI Ltd. had been integrated into a single full-service banking company as ICICI Bank in May 2002.

- **Industrial Development Bank of India (IDBI):**

It was established on 1st July, 1964 under an act of Parliament as a wholly owned subsidiary of the Reserve Bank of India. In February 1976, its ownership was transferred to the Government of India and it was made as the principal financial institutions for coordinating the activities of institutions engaged in financing, promoting and developing industries in the country. Current shareholding of the Government of India is 58.47%.

Due to change in operating environment, Government of India decided to transform IDBI into a commercial bank. The IDBI (Transfer of Undertaking and Repeal) Act, 2003 was consequently enacted by Parliament in December 2003. The Act provides for repeal of IDBI Act, corporatisation of IDBI and transformation into a commercial bank.

The provisions of the Act have come into force from 2nd July, 2004 in terms of a Government Notification to this effect. The IDBI has already commenced banking business in accordance with the provisions of the new Act in addition to the business being transacted under IDBI Act, 1964.

- **Industrial Investment Bank of India Ltd. (IIBI):**

It was set up in 1971 for rehabilitation of sick industrial companies. It was again reconstituted as industrial reconstruction bank of India in 1985 under the IRBI Act, 1984. With a view to

converting the institutions, IRBI was incorporated under the Companies Act, 1956, as Industrial Investment Bank of India Ltd. (IIBI) in March 1997.
It offers a wide range of products and services, including term loan assistance for project finance, short duration non-project backed financing, working capital/other short term loans to companies, equity subscription, asset credit, equipment finance and investment in capital market and money market instrument.

- **Infrastructure Development Finance Company Ltd. (IDFC):**

It was incorporated in 1997. It was conceived as specialized institutions to facilitate the flow of private finance to commercially viable infrastructure projects through innovative products and processes. Telecom, power, roads, ports, railways, urban structure together with food and agriculture-related infrastructure.
Besides, it assists the development of urban water and sanitation sectors. It has also taken new initiatives in the areas of tourism, health care and education. It provides assistance by way of debt and equity support, mezzanine structures and advisory services. It encourages banks to participate in infrastructure projects through take-out financing for a specific term and at a preferred risk profile.

19. Differences between Commercial banks and Development banks

Basis for Comparision	**Commercial Bank**	**Development Bank**
Meaning	Commercial Banks are the banks that provide basic banking and financial services to individuals and corporates.	Development Banks are the banks which are set up to provide finance for infrastructural and economic development.
Nature	Reactive	Proactive
Set up	Set up under the Companies Act, as Banking Companies.	Set up under specialized act.
Source of funds	Raise funds from accepting public deposits.	Borrowing, grants and selling of securities.
Loans provided	Short and Medium-term loans	Medium and Long term loans

Orientation	Profit oriented	Development oriented
Purpose	To make a profit by lending money at a high rate of interest.	To achieve social profit, by providing funds for developmental projects.
Services offered	Legal, Business advice and Credit Investigation service are provided for a definite fee.	Counselling and Advisory service are provided for the development and promotion of the enterprise.
Clients	Individuals, and Business Entities	Government

20. Mutual Fund

A mutual fund is a common pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments, and other assets. Mutual funds are operated by professional money managers, who allocate the fund's assets and attempt to produce capital gains or income for the fund's investors.

Some common categories of mutual funds are:

- **Equity funds** - funds that invest only in stocks and other equity instruments
- **Debt funds** - funds that invest only in fixed income instruments
- **Money market funds** - funds that invest in short-term money market instruments
- **Hybrid funds** - funds that divide investments between equity and debt to create a balance

21. Features & Benefits of Mutual Funds

- **Risk diversification: -** Diversification of funds into equity and debt securities
- **Liquidity: -** The Investor can make partial or full withdrawal as per his/her requirement
- **Transparency: -** Investors know exactly where the money is being invested
- **Low cost: -** No entry load while investing in mutual funds
- **Professional Management:-** Industry experts manage the funds
- **Tax-efficient:-** The Investors get tax benefits in equity and debt funds
- **Flexibility: -** Flexibility to switch investment funds from one fund to another

22. **Disadvantages of Mutual Funds**

- **Costs to manage the mutual fund:** The salary of the market analysts and fund manager comes from the investors. Total fund management charge is one of the first parameters to consider when choosing a mutual fund. Higher management fees do not guarantee better fund performance.
- **Lock-in periods:** Many mutual funds have long-term lock-in periods, ranging from five to eight years. Exiting such funds before maturity can be an expensive affair. A specific portion of the fund is always kept in cash to pay out an investor who wants to exit the fund. This portion cannot earn interest for investors.
- **Dilution:** While diversification averages your risks of loss, it can also dilute your profits. Hence, you should not invest in more than seven to nine mutual funds at a time.

23. **Role of Mutual Funds in capital market Development**

As the definition of the Mutual Funds says that its a pool of collective investment by the different investors and institutions.

- It helps in arranging the money for investment purposes in the economy.
- It mobilise the small savings of the public through investment.
- We know that developing countries like India lacks capital accumulation. So mutual funds help in capital accumulation which is crucial for the development of a developing country like India.
- It discourages the idle hoarding of the money in the house.
- It helps in creating an environment of investment in the country.
- It is helpful in employment generation.

So in conclusion, it is wise to say that mutual fund helps in generating the money for the seeding of many big investment projects in the country. Therefore, it can be said that mutual funds play an important role to develop strong capital market.

24. Non-Banking Financial Companies (NBFC)

Non-Banking Financial Companies (NBFC) are establishments that provide financial services and banking facilities without meeting the legal definition of a Bank. They are covered under the Banking regulations laid down by the Reserve Bank of India and provide banking services like loans, credit facilities, TFCs, retirement planning, investing and stocking in money market. However they are restricted from taking any form of deposits from the general public. These organizations play a crucial role in the economy, offering their services in urban as well as rural areas, mostly granting loans allowing for growth of new ventures.

There are a huge number of NBFCs operating in our country. Some of them are:

Power Finance Corporation Limited
Shriram Transport Finance Company Limited
Bajaj Finance Limited
Mahindra & Mahindra Financial Services Limited
Muthoot Finance Ltd
HDB Finance Services
Tata Capital Financial Services Ltd
L & T Finance Limited
Aditya Birla Finance Ltd.

25. Difference between banks & NBFCs?

NBFCs lend and make investments and hence their activities are mostly similar to that of banks; however there are a few differences as given below:

i. NBFC cannot accept demand deposits;

ii. NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself;

iii. deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

26. Different types/categories of NBFCs registered with RBI

NBFCs are categorized

- in terms of the type of liabilities into Deposit and Non-Deposit accepting NBFCs,
- non deposit taking NBFCs by their size into systemically important and other non-deposit holding companies (NBFC-NDSI and NBFC-ND) and
- by the kind of activity they conduct.

Within this broad categorization the different types of NBFCs are as follows:

1. Asset Finance Company (AFC) : An AFC is a company which is a financial institution carrying on as its principal business the financing of physical assets supporting productive/economic activity, such as automobiles, tractors, lathe machines, generator sets, earth moving and material handling equipments, moving on own power and general purpose industrial machines. Principal business for this purpose is defined as aggregate of financing real/physical assets supporting economic activity and income arising therefrom is not less than 60% of its total assets and total income respectively.
2. Investment Company (IC) : IC means any company which is a financial institution carrying on as its principal business the acquisition of securities,
3. Loan Company (LC): LC means any company which is a financial institution carrying on as its principal business the providing of finance whether by making loans or advances or otherwise for any activity other than its own but does not include an Asset Finance Company.

4. Infrastructure Finance Company (IFC): IFC is a non-banking finance company a) which deploys at least 75 per cent of its total assets in infrastructure loans, b) has a minimum Net Owned Funds of Rs 300 crore, c) has a minimum credit rating of 'A 'or equivalent d) and a CRAR of 15%.
5. Systemically Important Core Investment Company (CIC-ND-SI): CIC-ND-SI is an NBFC carrying on the business of acquisition of shares and securities.
6. Infrastructure Debt Fund: Non- Banking Financial Company (IDF-NBFC) : IDF-NBFC is a company registered as NBFC to facilitate the flow of long term debt into infrastructure projects. IDF-NBFC raise resources through issue of Rupee or Dollar denominated bonds of minimum 5 year maturity. Only Infrastructure Finance Companies (IFC) can sponsor IDF-NBFCs.
7. Non-Banking Financial Company - Micro Finance Institution (NBFC-MFI): NBFC-MFI is a non-deposit taking NBFC having not less than 85% of its assets in the nature of qualifying assets which satisfy the following criteria:

   - loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs 1,00,000 or urban and semi-urban household income not exceeding Rs 1,60,000;
   - loan amount does not exceed Rs 50,000 in the first cycle and Rs 1,00,000 in subsequent cycles;
   - total indebtedness of the borrower does not exceed Rs 1,00,000;
   - tenure of the loan not to be less than 24 months for loan amount in excess of Rs 15,000 with prepayment without penalty;
   - loan to be extended without collateral;
   - aggregate amount of loans, given for income generation, is not less than 50 per cent of the total loans given by the MFIs;
   - loan is repayable on weekly, fortnightly or monthly instalments at the choice of the borrower

8. Non-Banking Financial Company – Factors (NBFC-Factors): NBFC-Factor is a non-deposit taking NBFC engaged in the principal business of factoring. The financial assets in the factoring business should constitute at least 50 percent of its total assets and its income derived from factoring business should not be less than 50 percent of its gross income.
9. Mortgage Guarantee Companies (MGC) - MGC are financial institutions for which at least 90% of the business turnover is mortgage guarantee business or at least 90% of the gross income is from mortgage guarantee business and net owned fund is Rs 100 crore.
10. NBFC- Non-Operative Financial Holding Company (NOFHC) is financial institution through which promoter / promoter groups will be permitted to set up a new bank .It's a wholly-owned Non-Operative Financial Holding Company (NOFHC) which will hold the bank as well as all other financial services companies regulated by RBI or other financial sector regulators, to the extent permissible under the applicable regulatory prescriptions.